Testimony

before the

Subcommittee on Housing and Community Opportunity
and
Subcommittee on Financial Institutions and Consumer Credit
at Joint Hearing regarding

"Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit"

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on behalf of
Low income clients of the National Consumer Law Center
Consumers Union
National Association of Consumer Advocates

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Chairman Ney and Mrs. Waters, Chairman Bachaus and Mr. Sanders, and members of both subcommittees, we thank you for inviting us to testify today regarding the need to protect homeowners from abusive credit practices. I testify here today on behalf of the low income clients of the **National Consumer Law Center**[1]**,** as well as the **Consumers Union,** and **National Association of Consumer Advocates.**[2] The clients and constituencies of these legal services programs and consumer groups collectively encompass a broad range of families and households who have been affected by predatory lending.

The issues that you are requesting input on today are complicated and controversial. There are three distinct and diverse interests in this debate –

- the **homeowners** (and their representatives), who want the rules changed to eliminate, or at least reduce, predatory lending;
- the **originators** of subprime mortgage loans, who have a profitable market in the

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[1]The **National Consumer Law Center,** Inc. (NCLC) is a non-profit Massachusetts Corporation, founded in 1969, specializing in low-income consumer issues, with an emphasis on consumer credit. On a daily basis, NCLC provides legal and technical consulting and assistance on consumer law issues to legal services, government, and private attorneys representing low-income consumers across the country. NCLC publishes a series of sixteen practice treatises and annual supplements on consumer credit laws, including Truth In Lending, (4th ed. 1999) and Cost of Credit (2nd ed. 2000) and Repossessions and Foreclosures (4th ed. 1999) as well as bimonthly newsletters on a range of topics related to consumer credit issues and low-income consumers. NCLC became aware of predatory mortgage lending practices in the latter part of the 1980's, when the problem began to surface in earnest. Since that time, NCLC's staff has written and advocated extensively on the topic, conducted training for thousands of legal services and private attorneys on the law and litigation strategies to defend against such loans, and provided extensive oral and written testimony to numerous Congressional committees on the topic. NCLC's attorneys were closely involved with the enactment of the Home Ownership and Equity Protection Act in Congress, and the initial and subsequent rules pursuant to that Act. NCLC attorneys, on behalf of their low income clients, have actively participated with industry, the Federal Reserve Board, Treasury, and HUD in extensive discussions about how to address predatory lending.

[2]**Consumers Union Consumers Union,** the nonprofit publisher of Consumer Reports magazine, is an organization created to provide consumers with information, education and counsel about goods, services, health, and personal finance; and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of Consumer Reports, its other publications and from noncommercial contributions, grants and fees. Consumers Union's publications carry no advertising and receive no commercial support.

The **National Association of Consumer Advocates** (NACA) is a non-profit corporation whose members are private and public sector attorneys, legal services attorneys, law professors, and law students, whose primary focus involves the protection and representation of consumers. NACA's mission is to promote justice for all consumers.

current legal structure, and who want to be able to continue in this profitable endeavor; and

- the **secondary market,** which is generally not directly involved in the making of predatory loans,[3] but which is making a lot of money by securitizing subprime loan mortgages.

Each of these parties has a different perspective on the way that the issue of predatory mortgage lending is resolved, but one thing is clear – a truly effective resolution cannot make all parties happy. The problem of predatory lending cannot be addressed without pinching the interests of either the originators or the secondary or market, or both.

We provide our answer to the question posed by the Committees in the following parts of this testimony:

I. The Problem to be Addressed – Stopping Predatory Lending, *Not* Preserving Access to Credit.
II. Necessary Steps to Address Predatory Mortgage Lending.
III. The Importance of Assignee Liability.

I. The Problem to be Addressed – Stopping Predatory Lending, *Not* Preserving Access to Credit

The question to be addressed by witnesses in this hearing is:

> "The Subcommittees are particularly interested in possible solutions, implemented both in the origination process and in the secondary market for subprime mortgage loans, designed to eliminate abusive lending practices while also preserving and promoting access for consumers to affordable credit."

We believe that when addressing the problem of predatory mortgage lending, the emphasis should be on *stopping the problem, not preserving access to credit.* Preserving access to credit is *not* the problem in today's market. There is so much access to credit that American consumers are overwhelmed by it, and harmed by it. Too much credit is not a good thing. Too much credit drives loss of equity, bankruptcies, insolvencies, and foreclosures. Too much credit only benefits the creditors – not the consumers.

In the early 1980s, this nation did face a crisis of affordable credit, and it was necessary to

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[3]It should be kept in mind that at least one large player in the secondary market for subprime loans – Lehman Brothers – has been found by a jury to be *directly* involved in and responsible for millions of dollars of predatory loans. *In re First Alliance Mortg. Co.* 298 B.R. 652 , (C.D.Cal., Jul 30, 2003).

change the laws to deal with this problem. Laws were changed, starting with the 1980 passage of the Depository Institution Deregulation and Monetary Control Act ("DIDMCA") and the Alternative Mortgage Transaction Parity Act ("AMTPA"), passed in 1982.[4] The intent of both of these laws was to loosen the effects of state limits on interest rates and loan terms which were temporarily strangling access to credit necessary to achieve homeownership. These two laws preempted state consumer credit protection laws applicable to mortgages, unless the individual states acted within a short time frame to preserve the ability to govern the interest rates for first mortgage loans, and the terms for alternative credit products. Only a small minority of states were able to act quickly enough to maintain this prerogative.[5] The net effect of these two federal laws passed in the early 1980s to address the real credit crunch of the time was to remove from most states their historic ability to set interest rate ceilings on first mortgage loans and limits on alternative mortgage lending.

Now, in the early years of the Twenty First Century, the problem is that too much credit is not just available, but is being pushed on consumers.[6] In fact, the success of the secondary market's ability to provide plentiful money to originators of subprime loans has created its own momentum for the continued escalation of subprime lending. In other words, the fact that money is available to be lent in the subprime mortgage market has *pushed* more loans than the borrowers themselves have needed. The driving force behind many subprime mortgages is *not* the need of the borrower to refinance a mortgage, it is the need of the originator and the secondary market to fill a securitization. In a typical securitization, the money is provided by the secondary market, and the commitment to make loans for this total amount of money is made *before* the loans are made to individual borrowers.

Thus, the subprime market is a *push market;* much of the lending is only to meet the securitization needs of the originators and the investors. That is what is causing many of the problems of predatory lending – incentives are built into the system to make loans, even when they won't perform. The loans must be made to fill the securitization commitments, and if there are problems with the performance of the loans, these can simply be addressed by refinancing the loan. The successive refinancings deplete the equity in the homes, until finally the homeowner is driven to foreclosure. But only the last loan in the series appears to be flawed, only the one which does end in foreclosure. The previous loans, all of which were probably just as over priced and unnecessary as the last one, appeared to be performing loans, because they were paid off by

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[4]*See* Cathy Lesser Mansfield, *The Road to Subprime "Hel" was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market,* 51 S.C.L. Rev. 473 (2000).

[5]The following fourteen states preserved their ability to regulate interest rates for first mortgage loans: Colorado, Georgia, Hawaii, Idaho, Iowa, Kansas, Maine, Massachusetts, Minnesota, Nebraska, Nevada, North Carolina, South Carolina, Wisconsin. Only six states preserved their ability to regulate alternative mortgage transactions. Arizona, Maine, Massachusetts, New York, South Carolina, and Wisonsin.

[6]Ira Goldstein, *Predatory Lending: An Approach to Understand and Identify Predatory Lending,* The Reinvestment Fund, http://www.trfund.com/policy/FordForWeb.pdf.

refinancing.

To address predatory lending, we must first recognize there is a push market and that it must be stopped. Money should be available for subprime lending, but it need not be available in the current quantities. To change this dynamic some significant changes to the laws of this nation must be made.

The 1990s saw the phenomenal growth in the use of asset-based securities to fund an ever increasing supply of mortgage credit.[7] Creating capital flow in this way for subprime mortgage lenders took off following 1994. In that year, approximately $10 billion worth of home equity loans were securitized.[8] By the end of 1997, the volume had leaped to about $90 billion.[9]

While subprime mortgage lending has escalated dramatically, there has not been a similar increase in the rise in homeownership. Homeownership has only increased in the past 20 years from 64.8% of American households in 1982, to 67.9% in 2002[10] an increase of 4.8%. Subprime mortgage lending instead has largely been a *mistaken* way that American households have handled their debt problems. The result has been a huge increase in the number of subprime mortgages made, a huge *reduction* in the amount of home equity Americans have accumulated, and an ever escalating increase in the number of foreclosures of subprime mortgages. Each one of these problems present separate, and damaging, stories for American families.

Wrong Message Sent by the Tax Code. In 1986, Congress changed the tax code to allow taxpayers to deduct the interest for consumer loans only if the loan is secured by the home. This allowed the lending industry to sell their product by promoting the message to homeowners that borrowing against home equity is sensible economic planning. Unfortunately, this is quite often incorrect, even for middle income families. For low income households, this tax deduction is generally of no benefit because the working poor have little or no federal income tax liability because of the earned income tax credit. Others are paying at the tax system's lowest tax rates.

One consequence of limiting deduction of consumer debts to home equity loans is that many Americans are now paying much more interest on consumer debt, albeit generally at a lower

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[7] *The Asset-Back Securities Market: The Effects of Weakened Consumer Loan Qualtiy,* FDIC Regional Outlook, Second Quarter, 1997.

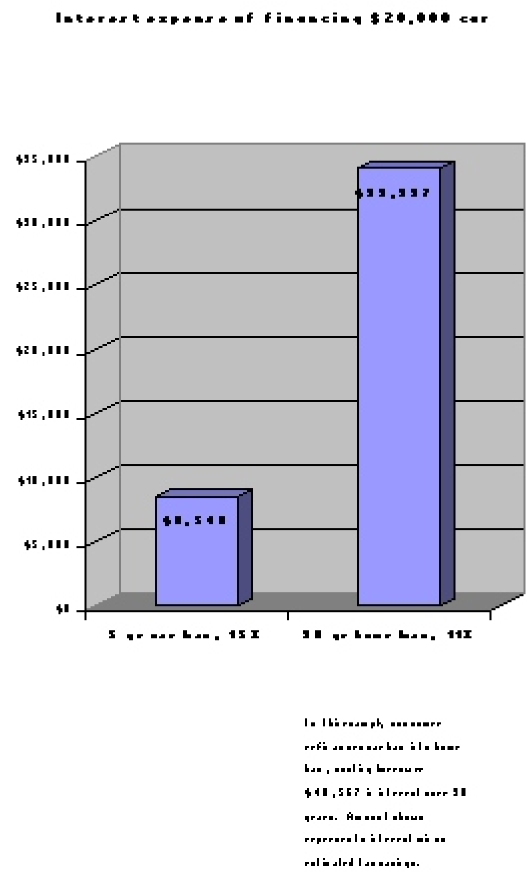
[8] Daniel Immergluck & Marti Wiles, *Two Steps Back: The Dual Mortgage Market, Predatory Lending , and the Undoing of Community Development,* at 12, Woodstock Institute (Nov. 1999).

[9] Glenn B. Canner, Thomas A. Durkin & Charles A. Luckett, *Recent Developments in Home Equity Lending,* 84 Fed. Res. Bull. 241, 250 (April 1998). *See also* U.S. Census Bureau, Statistical Abstract of the United States: 1999, Table No. 820 (this table reveals that by 1998, $411 billion of mortgage loans were held by private mortgage conduits, including securitized loans; table does not distinguish between prime and subprime lenders, however.

[10] U.S.Census Bureau *Housing Vacancies and Homeownership Annual Statistics: 2002*, Table 12.

rate per year. This is largely due to a lack of understanding and appreciation for the costs of financing debt over an extended period of time.

Generally, families are persuaded to pay off car loans, credit cards, and other non-housing related expenses with loans secured by their homes because of the perceived tax savings generated by the deductibility of interest related to home secured debt. This perception of savings is generally misplaced; because while the actual rate of interest is lower, the money is lent for a much greater length of time, resulting in a much higher cost to the homeowner, even after the tax benefits are considered. For example, consider the following example of a car loan refinanced into a home loan:



- *Car loan paid in installments.* A 5 year loan with an interest rate of 15% for $20,000, will have a **total interest expense on the loan of $8,548.**

- *Car loan refinanced into home equity loan.* A 30 year home loan for the same amount at an 11% interest rate effectively *costs* the homeowner more than four times as much in extra interest – even after counting the tax benefits. Just the interest charges on $20,000 over 30 years will be $48,567. Even if tax savings compensate for 30% of the interest expenses, the net cost of financing the car over the life of home mortgage is still 70% of $48,567 or **$33,997**.[11]

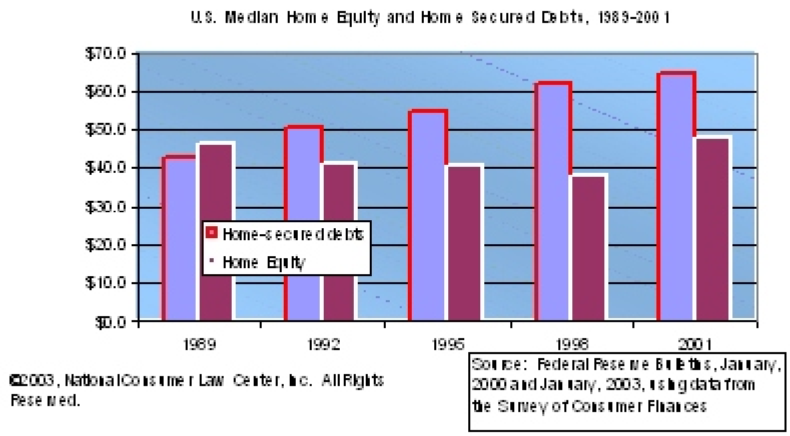
Depletion of Home Equity. A more serious consequence is the increase in the loss of equity for American households.[12] Even as the

[11]Even when the *present value calculations* are applied to both the five year car loan and the 30 year home loan, the comparison between the interest for the car loan to the total paid in interest *after tax deductions* for the home loan reveals that the 30 year home loan with the lower interest rate and the tax deductions is still almost three times as expensive as the five year car loan.

[12]Home equity is the difference between the value of the home and the loan amount. For example, a home with a value of $100,000 and an outstanding balance of the mortgage secured by the home of $60,000, would have

ratio of debt to savings for American families has risen over the past twenty years, the ratio of home equity debt to other debts has increased at a much greater pace.[13] This has several consequences:

- U.S. families are *switching* much of their debt from installment or credit card loans to home secured loans.



- This has the consequence of significantly reducing home equity savings for these households – and home equity saving has long been the traditional method of building assets for American families.

Consider the above chart, which shows the dramatic *increase* in home secured debt in the past decade, as well as the relative *decrease* in home equity. This bleeding of home equity causes a general diminution of the wealth and security of millions of American families.

Add this loss of equity to the escalating bankruptcies and insolvencies in this nation, and it becomes clear that the problem is not lack of access to credit, but too much access to the wrong kind of credit. In 2003, there were over 1.5 million bankruptcies, increasing again from the previous year.[14] But the number of bankruptcies filed by American households does not begin to tell the full story. Household debt is at a record high relative to disposable income.[15] Many families are too poor to file bankruptcy – we estimate that there are millions more people who are flat broke – too poor to file bankruptcy.

Foreclosures are skyrocketing, harming families and their communities. When compared to any other relevant measure – increase in homeownership, increase in number of mortgage loans, even the ratio of foreclosures per mortgage – the rate and number of foreclosures is

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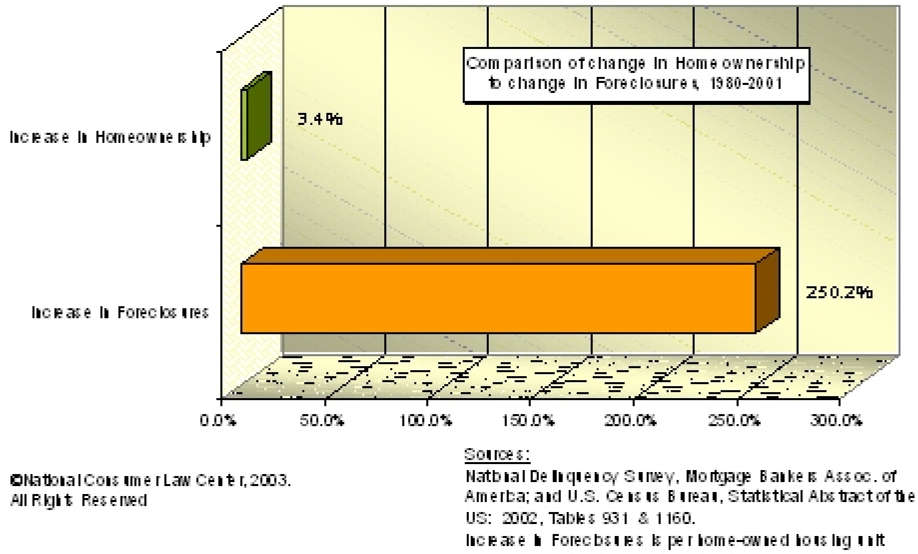
home equity of $40,000.

[13]Federal Reserve Bulletins, 2000 and 2001, using data from the Survey of Consumer Finances.

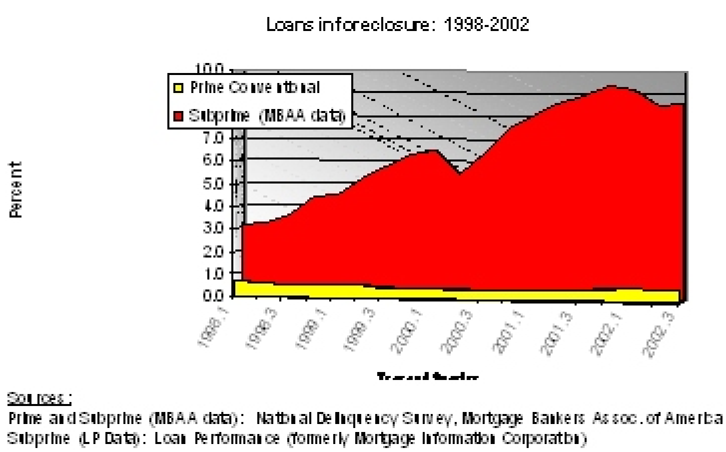
[14]American Bankruptcy Institute, http://www.abiworld.org/stats/newstatsfront.html.

[15]*Id.*

escalating at an alarming pace in this nation. The blame for this dramatic increase in foreclosures can be laid squarely at the doorstep of the subprime mortgage market, with its 8% foreclosure rate,[16] which has reached 12% or higher in some states.[17]



The escalating foreclosures in this nation are the fault of the subprime mortgage market. While the ratio of foreclosures to loans made has remained fairly steady over the years for the prime mortgage market, the same cannot be said for the subprime mortgage industry. In the prime mortgage industry, only 1 in 100 mortgages will go to foreclosure. In the subprime industry, the ratio is 1 in 12.



As Harvard Law Professor Elizabeth Warren recently pointed out – when comparing the degree of regulation in this nation for credit to other dangerous products – it would never be acceptable for a

[16]Prime and Subprime (MBAA data): National Delinquency Survey, Mortgage Bankers Assoc. of America, Subprime (LP Data): Loan Performance (formerly Mortgage Information Corporation) www.loanperformance.com.

[17]*Id.*

toaster to be sold which has a 1 in 12 chance of blowing up.[18] Why therefore should it be considered acceptable for an industry to exist which markets a product with an 8% expectation of failure? Yet this is exactly the failure rate of our subprime mortgage industry. The fact that the laws of this nation permit this is an indication that our policies to foster homeownership are being seriously undermined by the practices of the subprime mortgage industry. Something has to change – there must be a basic recognition by policymakers that unbridled credit is not helping America, it is not helping our communities, and it is actively hurting millions of American families.

By focusing on the subprime mortgage industry, it is not our intent to say that all subprime mortgages are bad, or that the entire industry provides predatory loans. Our goal is only to point out that a necessary objective of any laws designed to address predatory lending in a meaningful way *must* include the recognition that the effect of those laws will be to cut back on a sizeable portion of those mortgages which result in a) an unnecessary loss of equity for homeowners, and b) too high a risk of foreclosure. There is no reason that it should be considered acceptable for the foreclosure for subprime mortgages to be <u>eight times</u> the rate for prime mortgages. A 200% higher risk of foreclosure, as compared to prime mortgages – with its concomitant devastating consequences for the homeowner, the family and the community – should be the maximum which is acceptable.

II. Necessary Steps to Address Predatory Mortgage Lending

Enforcement of Existing Laws Will *Not* Stop Predatory Lending. It is not at all difficult to name the predatory characteristics of a predatory mortgage loan. There is no doubt that some of the problem in the marketplace can be traced to outright fraud and unfair or deceptive acts and practices, which are already illegal under many state laws.[19] However, many of the standard predatory characteristics of problem mortgage loans are perfectly legal under the current regime of federal, and most state, laws.

Law enforcement is an important tool in the battle against predatory lending if it specifically addresses abusive practices used by many subprime lenders and ensures that borrowers have effective remedies. Misleading homeowners about the true costs of loans, charging more than was agreed to by the homeowner, tricking homeowners into agreeing to loans with unaffordable payments, and misstating the homeowner's household income on loan

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[18]Elizabeth Warren & Amelia Warren Tyagi, *The Two Income Trap: Why Middle Class Mothers and Fathers are Going Broke*. 2003, chapter 6.

[19]To be clear – fraud is illegal under every state's common law. However, not every state has comprehensive statutes prohibiting unfair and deceptive activities in mortgage loans. Many state statutes only prohibit deception – unfairness is not addressed. Many state statutes on unfair or deceptive practices either do not cover mortgage transactions or do not cover transactions which are governed in any way by another law. National Consumer Law Center, *Unfair and Deceptive Acts and Practices* (5th ed. 2001), Chapter 2.

There is also some preemption of the application of state statutes on unfairness and deception asserted by the Offices of Thrift Supervision and the Comptroller of the Currency. *See e.g.* OTS Chief Counsel Letter of 2/24/96, and OCC Docket No. 03-16 68 Fed.Reg. 46119 (August 5, 2003).

applications, are all examples of frequent abusive behaviors that violate existing laws, yet require extensive legal resources to prove and obtain redress for the homeowner.

Even significant increases in the enforcement of existing laws would not fully address the problem of predatory mortgage lending. Only real legislative reforms will stop lenders from financing high points and fees, charging exorbitant prepayment penalties, using variable interest rate terms that only go up, refinancing special program mortgages for first time buyers into high cost credit, and similar legal but rapacious behavior. Only by changing the laws governing mortgage lending can we fully address the problem of predatory mortgage lending.

What is a predatory loan? Three of the worst predatory practices involve the charging and financing of high amounts of points and fees,[20] heavy prepayment penalties accompanied by higher than par interest rates for those borrowers, and flipping – or repeatedly refinancing the mortgage loan.[21] These practices typically provide the impetus for equity stripping (which results in the reduction or elimination of value of the consumer's major asset) and most reward the originator and subsequent holders of the loan (through an increase in the principal that is paid immediately to the originator upon sale to the secondary market or that is paid over time to the holder or recouped at foreclosure). The more the borrower is charged up-front, the more the lender and holder achieves a direct financial gain. Prepayment penalties provide additional profit to the holder when the loan is paid off and provide an incentive to flip the customer to trigger this

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[20]We include in our definition of fees the high costs of single premium credit insurance.

[21]There are numerous other predatory mortgage loan *indicators*, as set out below. Each must be addressed. But the single most important aspect of predatory lending is the financing of points and fees. Until this part of the problem is directly addressed, predatory lending will continue, without significant reduction of the problem:

- **Credit insurance packing** with high priced pre-paid term credit (life, disability and unemployment) insurance which add thousands of dollars in unnecessary costs to loans for borrowers who could obtain more reasonably priced credit insurance if paid on monthly basis;
- **Mandatory arbitration clauses,** which require the homeowner to arbitrate at considerable expense before arbitrators who have no incentive to follow consumer protection laws, and whose decisions are not reviewable by any court;
- **Spurious open end loans** whereby the lender is allowed to avoid making the more comprehensive disclosures required by closed end credit, and thereby avoid any chance of the homeowner asserting the right of rescission, as well as completely avoiding the restrictions under the Home Ownership and Equity Protection Act, regardless of the cost of the loan;
- **Paying off low interest mortgages** such as purchase money loans with FHA with much higher interest rate loans;
- **Refinancing unsecured debt** for which the borrower could not lose the home, with high interest rate debt which must be paid to avoid foreclosure;
- **Refinancing special no-rate or low rate mortgages** with high cost loans.
- **Yield spread premiums** paid to the broker even when the homeowner has already paid all closing costs, increases the cost of the loan.
- **125% loan to value loans** are predatory for a different reason than the typical predatory loan we most often seen in low-income communities. These loans effectively prohibit homeowners from selling their homes or filing bankruptcy to escape unaffordable debt, without losing their home.

income stream.

If the homeowner is unable to continue paying a loan, the lender or holder often refinances to make the loan "performing." However, this just means more profit for the lender since a new round of points and fees are added to the principal, and a prepayment may be collected as well. So long as there is sufficient equity in the home (and there generally is plenty), this lender *benefits* every time the borrower defaults. A default provides the lender with reason to make a new loan, and charge more points and fees. This creates another immediate opportunity to turn a quick profit. Even if the borrower does not default, predatory lenders convince borrowers to refinance their loans and receive a small amount of additional cash, thus taking advantage of the large prepayment penalty typically included in these loans.

Predatory lending is causing the massive loss of both equity and homes because the current legal and economic regime allows – indeed encourages – lending practices which reward lenders for making loans that are unnecessary, are unaffordable, bleed equity, and lead to foreclosure.

The government, as well as the housing and lending industries, has done an excellent job in recent years of expanding programs to establish new homeownership opportunities for low-income families. The next challenge is to enhance the long term sustainability of the homeownership experience for these families. The ultimate success of homeownership as an asset building strategy will be measured by the degree to which new homeowners are able to afford necessary home maintenance, avoid foreclosures, build equity in their homes, and use their equity effectively as wealth. As should be clear from the discussion in Part I above, the market does not work to protect homeowners from abusive mortgage loans.

In 1994, Congress passed the Home Ownership and Equity Protection Act (HOEPA) to prevent some predatory lending practices after reviewing compelling testimony and evidence presented during a number of hearings that occurred in 1993 and 1994. This law created a special class of regulated closed-end loans made at high rates or with excessive costs and fees. Rather than cap interest rates, points, or other costs for those loans, the protections essentially prohibit or limit certain abusive loan terms and require additional disclosures. HOEPA's provisions are triggered if a loan has an APR of 10 points over the Treasury security for the same term as the loan, or points equal to more 8% of the amount borrowed.[22]

It was hoped that HOEPA would reverse the trend of the past decade, which had made predatory home equity lending a growth industry and contributed to the loss of equity and homes for so many Americans. However, by passing HOEPA, Congress has already recognized two essential truths: that there are some loans for which the marketplace does not effectively apply restrictions; and government must step in to provide balance to the bargaining position between borrowers who either lack the sophistication to avoid bad loans or do not believe they have a

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[22]15 U.S.C. § 1602(AA)(1)(B).

choice if they want the credit. Unfortunately it is clear that HOEPA has not stopped predatory lending. Indeed, the problem has only grown worse in the eight years since it has become effective.

The Shape of Reform. A key facet to resolving the problem of predatory lending is the limitation on the financing of points and closing costs. Loans covered would be prohibited from financing all but a very few number of points and closing costs. Ideally, we would make this number zero, with the only exception for *bona fide* discount points used to buy down the loan rate in a legitimate way.[23] This would require that the lender pay all of the costs of closing the loan from the proceeds of the loan, including the broker fees, and recoup them through the interest payments on the loan.[24] While the rate of interest charged the borrower will increase slightly, the up-front fees will be brought to 0. If the borrower desires *to buy down* the loan rate by directly paying points, the borrower can do so in a seamless, transparent exchange – lower interest rate in exchange for a certain number of points. The confusion and lack of transparency that typifies the current closing process would be eliminated. More importantly many of the driving forces behind the making of a predatory loan would no longer exist.[25]

There are a multitude of clear benefits which would flow from a strict requirement that only *bona fide* discount points be permitted to be charged to the borrower at a loan closing:

- <u>Less equity will be stripped from the home.</u> The amount of money that the borrower owes interest on will be much closer to the amount which benefits the borrower. Every payment the borrower makes will reduce the loan amount. Even if there are repeated refinancings, the loan amount will not rise, unless the borrower is receiving cash out. The equity in the home is no longer the source of financing the loan – the loan can only be financed through the borrower's income.

- <u>The lender will have the incentive to make these loans affordable.</u> Currently, a typical predatory mortgage transaction creates thousands of dollars of immediate profit to the lender upon sale of the loan to an investor. Under the current system, when the borrower refinances the loan, the lender sees a substantial profit, providing an incentive to the lender to encourage refinancings, regardless of whether the borrower can actually afford to repay

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[23]We acknowledge that political realities may force the percentage of permitted fees to be greater than zero, but the logic of the analysis is best illustrated with zero points and fees (excluding *bona fide* points) allowed.

[24]Borrowers would still pay fees for services and products which they choose to purchase which are not required by the lender for the closing of the loan – homeowner's title, home inspection, their own attorney to review the transaction, etc.

[25]We acknowledge that this proposal will be wildly unpopular with many in the settlement services industry (as is evident from the response to HUD's proposal on RESPA). It is also essential to recognize that our proposal is significantly different from HUD's in that it would involve a change in the *law*, rather than simply regulations, such there would not be the serious problems which will flow from HUD's current proposal with determining compliance with the Truth in Lending Act.

the refinanced loan. Yet, if the lender only reaps a benefit from the loan through the *payments* the lender has a clear incentive to make sure that the borrower can afford the payments.

- The market will work to keep the interest rate on these loans competitive. So long as the borrower has not invested a significant amount of money in each loan – as is done when thousands of dollars in points and fees are financed – there is little to stop the borrower from shopping for a lower rate loan when his credit improves, or interest rates fall - just as is done in the prime market. As a result, when the loan is first made, the wise subprime lender will make the rate only high enough to cover the costs, the real risk, and a reasonable profit. If more is charged, the borrower will be able to refinance at a lower rate with a competitor.

- The cost of the loans will be transparent – even to the *least sophisticated* consumer. The complexity in today's mortgage shopping flows from the indecipherable combination of interest points and *some* fees, not all of which are included in the finance charge, and thus in the annual percentage rate.[26] If all costs to close the loan are paid by the lender and the only measurement of the loan's cost is the interest rate – except when the borrower chooses to pay *bona fide* discount points – even the least sophisticated consumer can tell that a loan with an interest rate of 9% is less expensive than a loan with an interest rate of 10%. But who among even sophisticated consumers can actually decipher the better deal between a 9% loan with 6 points and $4,000 in closing costs, as compared to a 10% loan with 2 points and $3,000 in closing costs and a prepayment penalty?

- With limits on prepayment penalties, a usury cap is less necessary. It has been said that the reason for prepayment penalties in subprime loans is due to the faster refinancing of these loans.[27] Indeed subprime loans are generally refinanced sooner than prime loans, however, this is because the push market in the subprime industry drives this refinancing.[28] However, if subprime loans were actually more competitive, and originators no longer had the incentive of the fast profit from the loan origination process itself, there would be no reason for subprime loans to refinance at a faster pace than those in the prime market. Thus the current arguments supporting prepayment penalties in the subprime market would no longer be applicable – and prepayment penalties would only be appropriate in

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[26]Under the Truth in Lending Act, the annual percentage rate includes the interest charged on the loan, all points, all broker fees, and only some of the fees charged for closing a home mortgage loan. 15 U.S.C. § 1605(e), 12 C.F.R. § 226..4(c)(7). This inclusion of some, but not all, fees leads to an imperfect and litigation inviting calculation of the finance charge. The question of which fees should be included and which fees excluded from the finance charge is the most litigated issue under both HOEPA and the Truth in Lending Act.

[27]Eric Stein, *Quantifying the Cost of Predatory Lending*, Coalition for Responsible Lending, July 25, 2001 at 9. http://www.predatorylending.org/pdfs/Quant10-01.PDF.

[28]*Id.*

situations where they were legitimately exchanged for a *bona fide* reduction in the interest rate. As a result, real limits on the amount of prepayment penalties and the time within which they can be charged on a loan would be appropriate. With these two protections – strict limits on 1) points and fees and 2) prepayment penalties – a usury cap would be less necessary, because the market actually might work in a competitive manner even for subprime borrowers.

- Liability issues would be clear and TILA litigation issues would be reduced significantly. Most of the actual and feared litigation under the Truth in Lending Act surround the issue of whether fees are justifiably excluded from the finance charge.[29] Almost all of the litigation under HOEPA regards the issue of whether a loan is properly considered *not* to be a HOEPA loan based on the lender's calculation of the fees included in the points and fees trigger for HOEPA loans.[30] With all of these fees paid by the lender and already included in the interest rate – all of this confusion and potential litigation evaporates.

III. The Importance of Assignee Liability.

Background. In order to obtain cash to fund their operations, and to limit the risk associated with the extension of credit, many creditors sell obligations that they receive from borrowers to third party creditors who may or not have had connection with the original credit transaction. This pattern of financing retail credit through a secondary market prevails in both commercial and consumer transactions and has been encouraged by the Uniform Commercial Code ("UCC"). One of the primary mechanisms to encourage this flow is the holder in due course doctrine, which permits those who purchase "negotiable instruments"[31] to protect themselves from claims of any other parties, and to free themselves from many, but not all, defenses to payment on the instrument.[32] The idea is that an investor can purchase negotiable instruments with limited risks. If an instrument appears valid on its face, the investor does not worry that the instrument might have been stolen, or that the maker of the instrument (*e.g.* the borrower) might

[29] *See generally,* National Consumer Law Center, *Truth in Lending* (4th ed. 1999) § 10.2.4.

[30] 15 U.S.C. § 1602 (aa)(4); *see e.g. Cooper v. First Gov't Inv. Corp.* 239 F. Supp.2d 50 (D.D.C. 2002).

[31] Checks and promissory notes are classic examples of instruments which generally fall within the UCC definition of a "negotiable instrument." UCC § 3-104.

[32] UCC § 3-305. Defenses which can be asserted against a holder in due course include the lack of the maker's capacity to execute the instrument, *e.g. Shepard v. First American Mortgage Co.*, 347 S.E.2d 118 (S.C. Ct. App. 1986), duress, the illegality of the instrument, misrepresentation of the essential character or terms of the contract, *American Plan Corp v. Woods*, 240 NE2d 886 (Ohio App. 1968), "fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn its character or its essential terms," and bankruptcy. UCC § 3-305(a)(1)(, (b). Usury can be a defense to a holder in due course, *see, e.g. Davenport v. Unicapital Corp.* 230 S.E. 2d 905 (S.C.1976), National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* (2d ed. 2000) § 10.6.1.3.2. For a discussion of fraud as a defense to a holder in due course, *see generally, Cost of Credit,* § 11.10.1; *§* Annot. 78 A.L.R.3d 1020 (1977).

have a contract dispute with the original lender, which would justify the maker's refusal to pay on the instrument. So long as the holder qualifies as a holder in due course, its risks are limited to the inherent risks of nonpayment because of the borrower's bankruptcy, etc., and to the possibility that the instrument itself was originally invalid.

The holder doctrine, however, is not absolute, and not all assignees can successfully assert it in response to a consumer claims and defenses. Most importantly, the Holder rule has been severely restricted for many consumer transactions, as the uneven bargaining power and unequal sophistication in these transactions meant the operation of the rule unfairly inflicted great hardships. Thus many state consumer credit *non-mortgage* statutes limit its impact, as does the FTC Preservation of Claims and Defenses Rule in the context of consumer retail sales.[33]

However, the FTC Preservation of Claims and Defenses Rule does not apply to most mortgage transactions.[34] Congress limited the circumstances in which assignees of high cost mortgage loans can assert holder in due course status for HOEPA loans.[35] Moreover, even under traditional UCC doctrine, both the underlying obligation and the assignee must meet UCC definitions of a "negotiable instrument" and "holder in due course," and a failure to meet all the technical elements will deprive the assignee of that status. Finally, certain types of claims and defenses may be asserted even against holders in due course.[36]

Application of the holder in due course doctrine is widely recognized to have been an unmitigated disaster for individual consumer debtors.[37] Take, for example, the situation where homeowners sign a loan and mortgage for home improvements secured by their home. The documents do not include the required FTC Notice of Preservation of Claims and Defenses, and the contact information provided by the home improvement contractor is useless. The home improvement work turns out to be shoddy and useless, but the assignee of the loan claims to have no knowledge of the status of the work, instead claiming it is an innocent third party assignee that

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[33]16 C.F.R. § 433; *see generally* National Consumer Law Center, *Unfair and Deceptive Acts and Practices* § 6.6.3 (5th ed. 2001).

[34]*Id.*

[35]§15 U.S.C. § 1641(d).

[36]Common law theories of participation, ratification, and acceptance of benefits with knowledge of the fraud can also make an assignee liable for the acts of the originator. *Maberry v. Said*, 927 F. Supp. 1456 (D.Kan.1996); *England v. MIG Investments, Inc.*, 93 F.Supp. 2d 718 (S.D. W.Va. 2000). *See generally* National Consumer Law Center, *The Cost of Credit: Regulation and Legal Challenges* (2d ed. 2000) § 10.6.1.3.

[37]Eggert, Kurt, *Held Up In Due Course: Codification and the Victory of Form Over Intent in Negotiable Instrument Law,* 35 Creighton L. Rev. 363 (Apr. 2002). For a discussion of the many problems that the holder in due course rule posed for consumers, *see* 40 Fed. Reg. 53506 (Nov. 19, 1975 (Statement of Basis and Purpose for adoption of FTC assignee notice requirement). *See also, Hearings on Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending, Before the Senate Comm. On Banking, Housing and Urban Affairs,* 1st Sess. 103d Cong. (Feb. 3, 17, 24 1993) (S. Hrg. 1030137).

merely wants its monthly payments. When the homeowners refuse to pay, the assignee claims the rights of a holder in due course and begins foreclosure proceedings. The UCC holder rules have at least the potential for taking away the homeowner's legal right to refuse to pay for defective goods and services.[38]

Previous Recognition of Fault of Secondary Market in Predatory Mortgage Lending. When Congress enacted HOEPA in 1994 it recognized that the growth of the secondary market was one of the factors contributing to the "equity skimming" by lenders in the 1980s. The unethical contractor or mortgage lender could make an overreaching loan without fearing any consequences, because it received its money, then is able to pass the risk on to the secondary market purchaser. Too many of those purchasers, in turn, do not assure that they are doing business with reputable, ethical originators, since they can use the holder doctrine as a shield to protect themselves from the borrowers' defenses.[39] As a consequence, assignees of HOEPA loans are subject to *all* claims (not just TILA claims) and defenses of the borrower which could have been raised against the originator. However, the assignee's liability that is extended based solely as the result of this HOEPA language is limited to the total paid by the borrower offset against the remaining indebtedness.[40]

To alert buyers of HOEPA loans of the potential liability, HOEPA loans are required to carry a prominent notice. However, the fact that the loan does not include the notice does not relieve the holder of liability. The only way that a holder can avoid the liability associated with a HOEPA loan is to prove by a preponderance of the evidence that it could not, with due care, have determined that a reasonable lender, exercising due diligence after looking at all the relevant documents, could not tell that this was a HOEPA loan.[41]

Any new rules that Congress establishes to address predatory lending must include some reasonable degree of liability for assignees. Without any liability for assignees, consumers are left without viable means to defend themselves from foreclosures and collection actions, even when

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[38]In fact, many courts reviewing such home improvement contracts determined that the finance company purchasing such home improvement contracts have not acted in good faith and without notice of the defenses and were therefore not a holder in due course. *See, e.g. Fin. Credit Corp. v. Williams,* 229 A.2d 712 (Md. 1967); *General Inv. Corp. v. Angelini,* 278 A.2d 193 (N.J. 1971); *see generally* Annot. 36 A.L.R. 4th 212 (1985).

[39]*Hearings on Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending, Before the Senate Comm. On Banking, Housing and Urban Affairs,* 1st Sess. 103d Cong. (Feb. 3, 17, 24 1993) (S. Hrg. 103-137).; The Home Equity Protection Act of 1993, Hearings on H.R. 3153 Before the Subcommittee on Consumer Credit and Insurance of the House Committee on Banking, Finance and Urban Affairs, 103d Cong., 2d Sess. (Mar. 22, 1994).

[40]15 U.S.C. 1641(d)(2).

[41]This places a burden on the prospective purchaser to review all the documentation, instead of just the note alone. Any documents which would itemize all dispersements, include fees and costs, must be reviewed. 15 U.S.C. § 1641(d).

claims and defenses are available. Also, if originators know that they effectively wash the loans of dirty – and illegal – deeds by selling them to the secondary market, there are no incentives built into the system to encourage compliance.

Congress recognized in 1994 just what the next Congress dealing with predatory mortgages must recognize – that the secondary market is the best policeman of the rules. The secondary market has access to the necessary information about each loan and each originator – because this information can be required to be provided with the purchase of each loan. The secondary market has the wherewithal to shut down access to money for bad actors, but will only have the incentive to do so if the failure to do so will cost the investors.

Most importantly consider the question of who should bear the risk in a faulty transaction. Assume 1) an *innocent consumer* (victim of an illegal loan), 2) an *originator guilty* of violating the law and profiting from the making of an illegal loan, and 3) an *innocent holder* of the illegal note. As between the two innocent parties – the consumer and the holder – who is best able to protect against the risk of loss associated with the making of an illegal loan? It is clear that the innocent party who is best able to protect itself from loss resulting from the illegality of another is not the consumer, but the corporate assignee.

An appropriate analogy is to the liability for stolen property. Again assume two innocent parties – the victim of the theft and the buyer of the stolen property. The law is clear that as between these two, the victim always gets the stolen property back.[42] The only way in which this analogy is different from the situation of the secondary market and predatory loans is that the secondary market is run by respected – and wealthy – members of the business community.

It is important to emphasize here that the secondary market has been found to be directly involved and at fault in predatory lending. In the recent FAMCO case, Lehman Brothers was found to have directly furthered the fraud of the originators in their predatory mortgage lending.[43]

Balancing the Real Need for Access to Funds in the Secondary Market. The secondary market does fill the important job of providing access to more capital for the subprime mortgage market. So a reasonable, balanced approach of holding the secondary market liable for the violations of the loan originators is necessary to ensure that some funds are still forthcoming. Just as it would not make sense for there to be *no* assignee liability, full assignee liability for an indeterminate amount of claims and damages may well shut down this funding source. While we believe some reduction in funding to the subprime market is appropriate, and we expect that one of the chief goals of legislation truly designed to stop predatory lending will intend to reduce inappropriate and overly expensive mortgage loans, we agree that there need not be unlimited

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[42]*See e.g.* Patty Gerstenblith, 11 Cardoza J.Int'l and Comp. L.409, *Acquisition and Deacquisition of Museum Collections and the Fiduciary Obligations of Museums to the Public,* Summer 2003.

[43]For a factual discussion of this case, *see In Re First Alliance Mortgage Company,* 298 B.R. 652 (C.D.Cal. 2003).

liability to assignees.

In the recent battles over assignee liability in the states, the various rating agencies have indicated on several occasions that they are able to fund lending in areas where there is assignee liability, but they need clear rules and clear limits on liability. **There should be no misunderstanding – the rating agencies have NOT refused to rate any loans with assignee liability.** Instead the rating agencies have specified that the damages must be determinable. If these damages are capped – and thus can be determined to be no more than a specific amount, then the loans, *even with assignee liability,* will be securitized and rated:

> Standard & Poor's defines assignee liability as liability that attaches to a purchaser simply by virtue of holding a predatory loan. If Standard & Poor's determines that there is no assignee liability, Standard & Poor's will generally permit loans covered by the statute to be included in rated transactions. If, on the other hand, a given state's anti-predatory lending statute does permit assignee liability, Standard & Poor's will evaluate the penalties under the statute. If damages imposed on purchasers are not limited to a determinable dollar amount, that is, the damages are not capped, Standard & Poor's will not be able to size the potential liability into its credit analysis. Therefore, these loans cannot be included in rated transactions. *If, on the other hand, monetary damages are capped, Standard & Poor's will be able to size in its credit analysis the potential monetary impact of violating the statute. (Emphasis added.)*[44]

Fitch has similarly stated that the current HOEPA standard for assignee liability was an acceptable method of measuring potential risk. Recently, when referring to Oklahoma's new law on predatory lending, Fitch said –

> Fitch has previously indicated that it will not rate REBS transactions that contain loans which are originated in jurisdictions that have enacted legislation that may result in unlimited purchaser or assignee liability for predatory lending practices of an originator, broker or service.
>
> . . .
>
> The potential damages described in the Act closely track potential damages described in 15 U.S.C.A. §§ 1640 and 1641, of the Truth in Lending Act (TILA). In fact, the language in the Act describing potential assignee liability is virtually identical to the relevant sections of the federal Home Ownership and Equity Protection Act

[44]Natalie Abrams, *Anti-Predatory Lending Laws Assume a Prominent Role in the U.S. REBS Market,* Ratings direct, www.ratingsdirect.com, Oct.7, 2003.

> of 1994 (HOEPA), which amended the TILA. *Since the Act provides for assignee liability which, although greater than the loan balance, is limited, Fitch will rate REBS transactions containing all mortgage loans, . . . (Emphasis added).*[45]

Conclusion

Predatory lending is a serious problem in this nation, which is harming millions of homeowners, damaging communities, and undermining the national goals of advancing homeownership. Legislation that is seriously intended to address predatory lending must recognize that a significant factor in the problem is the availability of too much, inappropriate mortgage credit. However, unlimited assignee liability which will shut down all funds is not a helpful result. The answer lies in clear rules to stop predatory lending, with assignee liability capped at reasonable amounts. The goal must be to change the rules for mortgage lending in this nation so that no business can profit in the future from bad loans that plague America's homeowners.

In sum, we propose that legislation to address predatory lending include the following:

- Strict limits (ideally zero) on all points and fees which can be financed by lenders. Only discount points and prepayment penalties which are *bona fide* – actually in exchange for a truly negotiated reduced interest rate – should be permitted.
- Full assignee liability that is capped (per the current HOEPA rule) at the amount of the loan.
- The income tax rules should be amended to limit home secured debt to debt which is not only secured by the home, but is also obtained for reasons relating to the home. In exchange, individual taxpayers should be permitted some additional measure of deductions for personal credit *not* secured by the home.[46]

We also have suggestions for additional protections to deter foreclosures and add to valuable housing counseling resources, as well changes to the rules for Home Mortgage Disclosure Act to assist in enforcement of new and existing laws.

We remain happy to work on these and all other viable proposals to address the pernicious problem of predatory lending.

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[45] *Fitch Ratings Addresses Predatory Lending Legislation of Oklahoma,* October 30, 2003.

[46] We propose that changes to the tax code be essentially revenue neutral, to both the U.S. Treasury, and to most individual taxpayers, along the following basic guidelines: 1) Loans for home secured debt should be tax deductible only for that portion of the loan which is related to the purchase, repair or improvement of the home or related property, and 2) all individual taxpayers should be provided with a percentage of their income which can be deducted for expenditures spent for interest on consumer debt.